

Mitigating Federal Limitations on SALT Deductions: New State Laws and Tax Planning Techniques for Taxpayers

THURSDAY, SEPTEMBER 20, 2018, 1:00-2:50 pm Eastern

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Mitigating Federal Limitations on SALT Deductions

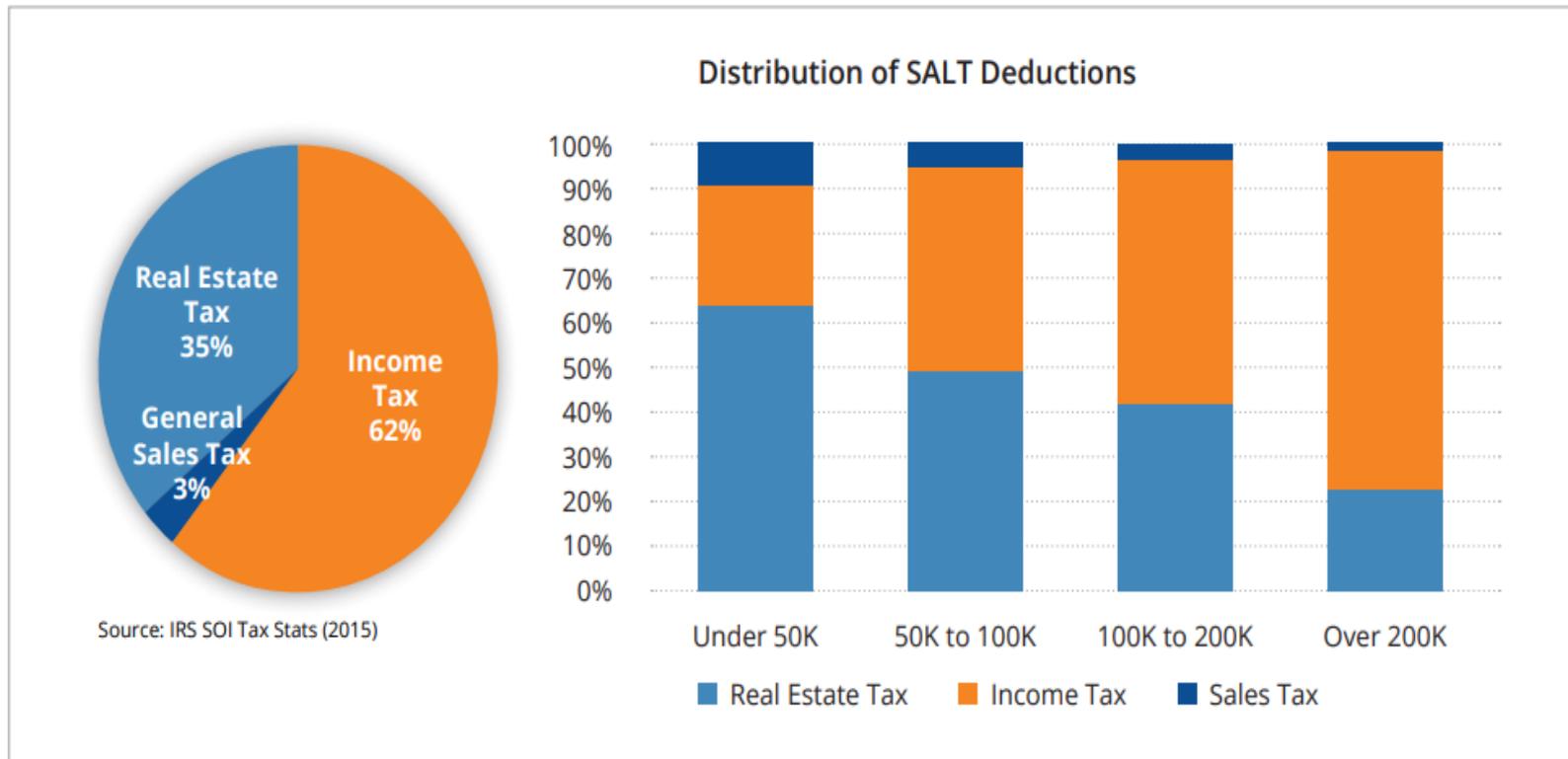
Federal Deduction for State and Local Taxes

Overview

- IRC § 164
 - “Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
 - (1) State and local . . . real property taxes.
 - (2) State and local personal property taxes.
 - (3) State and local . . . income, war profits, and excess profits taxes.”

Federal Deduction for State and Local Taxes Overview

Figure 1 — Distribution of the SALT Deduction



Government Finance Officers Association, *The Impact of Eliminating the State and Local Tax Deduction* (2017) (using 2015 IRS data).

Federal Deduction for State and Local Taxes

The Tax Cuts and Jobs Act

- The Tax Cuts and Jobs Act of 2017 (the “TCJA”) added subsection (b)(6) to IRC § 164.
- *Limitation on Individual Deductions for Taxable Years 2018 through 2025.*
 - “In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026 . . . the aggregate amount of taxes taken into account under paragraphs (1) [real property taxes], (2) [personal property taxes], and (3) [income taxes, among others] of subsection (a) and paragraph (5) [general sales taxes] of this subsection for any taxable year shall not exceed \$10,000.” IRC § 164(b)(6)(B).
 - “[A]n amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is imposed.”

Federal Deduction for State and Local Taxes

The Stakes

Top five states (by total SALT deduction claimed)

Jurisdiction	Amount of SALT Deduction	%	Avg. Amount Claimed
United States	\$552,700,000,000	100%	\$12,471
California	\$112,600,000,000	20.4%	\$18,438
New York	\$73,600,000,000	13.3%	\$22,169
New Jersey	\$32,200,000,000	5.8%	\$17,850
Illinois	\$24,100,000,000	4.4%	\$12,524
Texas	\$21,600,000,000	3.9%	\$7,824

Tax Policy Center, *State and Local Tax Deduction by State (1997 to 2015)*

Federal Deduction for State and Local Taxes

State Responses

- Many states responded to the enactment of the \$10,000 SALT deduction limitation almost immediately.
 - Charitable contribution tax credits.
 - Employment/payroll taxes.
 - Pass-through entity taxes.
- Connecticut, New York, and New Jersey were among the first states to act.

State Charitable Contribution Credits

State Charitable Contribution Credits

Background - Federal Deduction for Charitable Contributions

- IRC § 170
 - “There shall be allowed as a deduction any charitable contribution . . . payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.”
 - “[C]haritable contribution’ means a contribution or gift to or for the use of [among other entities] . . . [a] State . . . but only if the contribution or gift is made for exclusively public purposes.” (emphasis added).
- Several states had enacted programs that entitle donors to a state tax credit based upon certain charitable donations long before the TCJA’s passage.

State Charitable Contribution Credits

Background – State Tax Credits

- To blunt the impact of the \$10,000 cap, some states have enacted laws that enable the state and/or localities to create charitable trusts for public benefit to which state residents may make charitable contributions in exchange for state tax credits.
- For federal income tax purposes, the contribution is arguably a “charitable contribution” that is fully deductible under IRC § 170.
- Under the “full deduction rule,” the charitable deduction would not be reduced by the value of the state tax benefit.

State Charitable Contribution Credits

State Tax Credits

- **New York**
 - Creates a state-run charitable fund (the “charitable gifts trust fund”) for the benefit of New York health and education initiatives.
 - Allows a New York personal income tax credit equal to 85% of contributions to the fund in the immediately preceding calendar year.
- **New Jersey**
 - Authorizes localities to create charitable funds that give donors property tax credits of up to 90% of their contributions.
- **Connecticut**
 - Authorizes municipalities to provide residential property tax credits to eligible taxpayers who make contributions to certain organizations.
- **California (passed legislature, awaiting governor’s signature)**
 - Expands the College Access Tax Credit.

State Charitable Contribution Credits

Treasury's Response

- Notice 2018-54: Guidance on Certain Payments Made in Exchange for State and Local Tax Credits (Issued May 23, 2018).
 - “This notice informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.”
 - “The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers.”

State Charitable Contribution Credits

Treasury's Response

Proposed Regulations

- “[T]he Treasury Department and the IRS believe that when a taxpayer receives or expects to receive a state or local tax credit in return for a payment or transfer to an entity listed in section 170(c), the receipt of this tax benefit constitutes a *quid pro quo* that may preclude a full deduction under section 170(a).” (emphasis in original)
 - “[T]he amount otherwise deductible as a charitable contribution must generally be reduced by the amount of the state or local tax credit received or expected to be received, just as it is reduced for many other benefits.”
- “[T]he rules in these proposed regulations are based on longstanding federal tax law principles, which apply equally to taxpayers *regardless of whether they are participating in a new state and local tax credit program or a preexisting one.*” (emphasis added)

State Charitable Contribution Credits

Treasury's Response

Basis for Treasury's Conclusions

- The “*sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration.” *U.S. v. American Bar Endowment*, 447 U.S. 105, 116-118 (1986).
- Existing Treasury Regulations.
- According to Treasury, other authority that would appear to permit a full IRC § 170 deduction, e.g., Chief Counsel Advice Memorandum 201105010 (Oct. 27, 2010) (the “2010 CCA”), is distinguishable.
 - The 2010 CCA advised that taxpayers may take a deduction under section 170 for the full amount of a contribution made in return for a state tax credit, without subtracting the value of the credit received in return.

State Charitable Contribution Credits

Treasury's Response

IRS Notice IR-2018-178 (Sept. 5, 2018)

- “Business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses.”
- “[T]his general deductibility rule is unaffected by the recent notice of proposed rulemaking concerning the availability of a charitable contribution deduction for contributions pursuant to such programs. The business expense deduction is available to any business taxpayer, regardless of whether it is doing business as a sole proprietor, partnership or corporation, as long as the payment qualifies as an ordinary and necessary business expense. Therefore, businesses generally can still deduct business-related payments in full as a business expense on their federal income tax return.”

State Charitable Contribution Credits

Takeaways

- The proposed regulation appears to have blocked state efforts to circumvent the \$10,000 SALT deduction limitation vis-à-vis IRC § 170.
 - However, this has not completely stopped certain states from pursuing these programs. See, e.g., California S.B. 539.
- The proposed regulations affect similar state programs that were in existence before the passage of the TCJA.
- The IRS has expressly stated that these state charitable contribution credit programs should be available to business taxpayers as deductions for ordinary and necessary business expenses.

Payroll Taxes & Pass-Through Entity Taxes

New York

Employer Compensation Expense Program

- Optional payroll tax (“Employer Compensation Expense Tax” or “ECET”)
- Electing employers are subject to tax on payroll expenses paid to “covered employees,” i.e., employees whose wages are subject to withholding and who receive annual wages and compensation in excess of \$40,000.
- Gradually phased-in rate
 - 2019 – 1.5%
 - 2020 – 3%
 - 2021 and later – 5%
- Employee credit provided. May be carried forward to succeeding years.
- First election due December 1, 2018.

New York

Employer Compensation Expense Program

TSB-M-18(1)ECEP

- ECET is paid on the payroll expenses paid to each employee who is employed in New York.
- “The tests for determining whether an employee is employed in New York are the same tests used to determine whether an employee is employed in the Metropolitan Commuter Transportation District (MCTD), substituting New York State for the MCTD as the relevant geographic area.”
 - Localization
 - Base of operations
 - Place of direction and control

New York

Employer Compensation Expense Program

Calculating the Tax (TSB-M-18(1)ECEP)

- **Example 1:** An electing employer has three employees. Two of the employees earn less than \$40,000 annually. The third employee earns \$120,000 annually (\$30,000 each quarter). The third employee is not a covered employee for the purpose of the first quarter ECET filings, but at the time in the second quarter when the employee's total wages to date exceed \$40,000, the employee is deemed a covered employee and the employer is subject to the ECET.
- **Example 2:** Employee X receives an annual salary of \$300,000 from an electing employer. Employee X is employed by an electing employer in California from January 1 until November 30. On December 1, Employee X is transferred to New York State and is then employed by the electing employer in New York. Employee X received \$275,000 in wages while employed in California and \$25,000 in wages while employed in New York.

New York

Employer Compensation Expense Program

- Calculating the Tax (TSB-M-18(1)ECEP) (cont'd)
 - **Example 3:** Employee Y receives an annual salary of \$250,000 from an electing employer. Employee Y is employed by an electing employer in Georgia from January 1 until August 31. On September 1, Employee Y is transferred from Georgia to New York State and is then employed by the electing employer in New York. Employee Y received \$150,000 in wages while employed in Georgia and \$100,000 in wages while employed in New York.
- The proposed Treasury Regulations targeting the state charitable contribution credits did not address this type of program.
- Large employers may face administrative hurdles to implementation.

Connecticut

Pass-Through Entity Tax - Overview

- Enacted as part of Connecticut Senate Bill 11 (“S.B. 11”).
- Effective for tax years beginning on or after January 1, 2018
- Applies to:
 - S corporations;
 - Partnerships; and
 - Limited liability companies, treated as a partnership for federal income tax purposes.
- Members of relevant pass-through entities are entitled to claim an offsetting credit against their taxes equal to 93.01% of the member’s direct and indirect pro rate share of the tax paid by the pass-through entity.
- Excess credits are treated as a refundable overpayments.
- Provides credit for taxes paid to other jurisdictions.

Connecticut

Pass-Through Entity Tax - Computation

- The tax is imposed at a 6.99% rate
- Taxable income base
 - The separately and non-separately computed items, as described in Section 702(a) of the Internal Revenue Code to the extent derived from or connected to Connecticut sources;
 - Increased or decreased by applicable adjustments.
- If the taxable income computation results in a net loss, such net loss may be carried forward to succeeding taxable years until fully used.
- Special rules provided for tiered structures.
- Special rules provided for nonresident members.

Conclusion

- State tax charitable contribution credits may no longer be a viable option for circumventing the \$10,000 SALT deduction limitation.
 - Under the *quid pro quo* doctrine, the amount of the IRC § 170 deduction should be reduced by the value of the state tax benefit received in exchange for the charitable contribution.
 - However, business taxpayers do not appear to be affected per IRS Notice IR-2018-178, assuming the charitable contribution qualifies as an ordinary and necessary business expenses.
- The IRS has not yet expressed an intention to challenge other state efforts to circumvent the \$10,000 SALT deduction.
 - E.g., New York's Employer Compensation Expense Program, Connecticut's Pass-Through Entity Tax.

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